PART II

POLICY OF GOVERNMENT AND LABOUR MARKET

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POLITICAL INCENTIVES HAMPER THE CREATION OF HIGH-PAYING JOBS

Abstract

Do politicians want to pass policies that create high-paying jobs? Surely they do. And everything else equal, if given a choice between economic policies that increase salaries and wages and those that reduce salaries and wages, politicians would choose the former. Unfortunately, everything is not equal when political decisions are being made. No matter how good politicians' intentions are, in a democracy they have to get reelected if they are to continue serving the public. And as strange as it may sound, politicians often find it easier to get reelected by enacting policies that reduce salaries and wages than by enacting policies that increase them. The reason is that policies that do the most to increase the pay of workers do so indirectly by freeing up markets, and it is difficult for voters to see the connection between the higher pay and the actions of politicians. In other words, politicians are unlikely to receive credit for policies that are good for workers. On the other hand, policies that give the appearance of increasing pay, and protecting high-paying jobs, are commonly policies that reduce the general level of salaries and wages. This means that politicians are more likely to get credit for helping workers when they enact policies that reduce pay than when they enact policies that increase pay. This paper will explain why this perverse political incentive exists, and give examples to illustrate the problem.

Political Incentives Hamper the Creation of High-Paying Jobs

<u>Introduction</u>

Can politicians create more higher-paying jobs? It is clear that voters believe they can, which explains why politicians inevitably promise to create more jobs at higher pay when campaigning for votes. In fact politicians can enact policies that would increase the general level of wages in the economy. This doesn't mean, however, that much good will result from politicians trying to keep their high-wage promises. The problem is that the things politicians *can* do to increase wages are not the things they *will* do. There are two general types of policies that politicians can enact to increase the pay of workers. The first type are policies that work, but for which politicians are unlikely to get credit. The second type are policies that don't work, and almost always reduce wages and salaries, but which create the mirage of working in ways for which politicians can take credit.

Under political democracy there are strong incentives facing politician to take bold action with policies that benefit organized interest groups while appearing to promote desirable social objectives. Even when such policies are socially harmful, as they often are, they can increase the electability of politicians more than policies that promote the general interest of society indirectly by creating a setting in which people can improve their conditions through productive interaction with one another. There are two political problems with indirect approaches even when far more beneficial than direct approaches. First, the benefits are created so gradually and spread so widely that few will notice them, and 2) even if the benefits are noticed it is difficult, if not impossible, for the public to trace them back to particular policies and politicians, making it unlikely that politicians can claim credit for them. As Hayek (1979, p. 28) pointed out, politicians "who hope to be re-elected on the basis of what their party during the preceding three or four years has conferred in *conspicuous* special benefits on their voters are not in the sort of position which will make them pass the kind of general laws which would really be most in the public interest" (emphasis added).[i]

Policies to create high-paying jobs provide excellent, but unfortunate, examples of harmful policies that directly create conspicuous benefits being more politically popular than policies that indirectly create high-paying jobs but do so inconspicuously.

<u>Policies That Create High-Paying Jobs</u>

There are a number of policies, and policy changes, that would increase wages indirectly, and others that appear to increase worker wages, but actually reduce them. The former policies all do the one thing necessary for higher pay for workers—they increase labor productivity. The latter policies all reduce, or retard, labor productivity, and so reduce wages below what they would be otherwise. In this section I shall list and discuss some policies that increase wages. In the next section I list and discuss policies that are more popular politically, but which reduce wages.

Eliminate Restrictions on Imports

One of the most effective things that politician in any country can do to increase labor productivity and wages is eliminate tariffs and other restrictions on imports. Reducing import restrictions increases real wages in two ways. First, it reduces the prices workers have to pay for those goods and services that can be produced in foreign countries for less than they can be produced domestically. Second, it increases the competition domestic producers face from foreign producers, which directs workers into those employments in which they are most productive—in which they have a comparative advantage. Increased productivity is both necessary and sufficient to increase the general wage level. No one would deny that there are costs associated with workers losing jobs in less productive employments and having to find jobs in more productive employments, or that a few people will be unable to find new jobs that pay as much as the ones they lost. But no economy can prosper without open competition which keeps all resources, including labor, moving from less valued to more valued employments in response to a host of constantly changing conditions. And even those who end up with lower wages because of the adjustments competition forces upon them still earn far higher wages than they would in an economy where they, and everyone else, are protected against having to make such adjustments.

End Corporate Welfare

Import restrictions are a form of corporate welfare, but unfortunately not the only form. Businesses around the world have been successful at lobbied their governments for a large number of subsidies, regulations and restrictions on competition that transfer wealth to them by imposing cost in the form of economic inefficiency on the general public. If politicians started eliminating this corporate welfare, it would increase high-wage jobs in two ways. First it would allow the taxes needed to pay for many of the corporate subsidies to be reducing taxes, which would increase the productivity of the economy by reducing the distortions invariably caused by taxes (see the next subsection). Second, it would reduce the socially unproductive use of resources to lobby governments and increase the competition that directs labor and capital into more productive employments as determined by consumers spending their own money as opposed to politicians spending other people's money.

Lower Marginal Tax Rates

Every government, no matter how efficient it is, has to raise revenue to finance its activities and that means imposing taxes. Unfortunately, all taxes reduce economic productivity by putting a wedge between the price suppliers receive and demanders pay, thus eliminating mutually beneficial exchanges, and motivating people to devote resources to avoiding taxes rather than creating wealth. These distortions are commonly called dead-weight losses and are an inevitable cost of taxes, over and above the opportunity cost of the money raised. An effective way of reducing the dead-weight loss from taxation for any amount of revenue raised is by lowering the marginal tax rate and expanding the tax base by closing tax loophole. Doing this increase the general level of productivity, and in particular would increases the ability of exchanges between employers and employees to direct workers into their highest-valued employments.

Maintain a Stable Price Level

The federal government can do a lot to increase high-paying jobs by avoiding inflation, or maintaining a stable price level. Inflation erodes labor productivity, and lowers real wages, just as surely as it erodes the value of the dollar. The most destructive thing about inflation is that it distorts the information communicated by market prices, reducing the ability of market exchange to direct resources, including labor, into their most productive uses. Just as a yardstick ceases to be useful for measuring and comparing distances if its length is subject to sporadic change, so market prices are less useful for measuring and comparing values when the value of money is subject to sporadic changes. Also, inflationary distortions make it almost impossible to know what interest rate is appropriate when people borrow and lend money to finance long-term investments. So in an inflationary environment, many efficient capital investments that would increase the future productivity of labor—and increase future wages—never get made.

Reduce Special-Interest Government Spending

There can be no doubt that reducing government spending on special-interest programs would increase real wages by increasing the productivity of the economy. A major portion of federal spending is motivated by the ability of particular congressional districts or organized interest groups to capture benefits by spreading the costs over the entire taxpaying public. With those receiving most of the benefits paying only a small portion of the cost, the pressure is to expand the spending well beyond the socially efficient level. Again, resources are transferred from higher-valued uses to lower-valued uses, reducing the value of the goods and services available, and thereby reducing the real value of salaries and wages. Excess government spending is a negative externality, just like excess pollution, and the former is no less destructive of economic productivity, or does more to erode real wages, than the latter. If politicians worried about the negative externalities of pork-barrel spending as much as they claim to worry about those of excess pollution, the result would be less wasteful government spending and high-paying jobs.

Expand School Choice

Few, if any, contributions politicians could make to more high-paying jobs would be more effective than policies that improve education. Additional human capital acquired through better education increases the productivity of workers and the wages they earn. As long as government plays a major role in funding education, the best way to improve education is by requiring that schools compete for the students. As long as most students remain the captive clients of the public school lobby, the quality of education will remain poor despite the efforts of many excellent and hard-working teachers. Nothing would do more to improve education than having government fund the public schools indirectly through parents who could spend the money on the competitive school of their choice instead of directly providing education through monopoly government schools run by government employees. The resulting improvement in education and human capital would increase the productivity of workers and the number of high-paying jobs.

Eliminate the Minimum Wage

Eliminating the minimum wage would increase wages by increasing the human capital that, for many young people, is best acquired through on-the-job training. Minimum-wage legislation clearly creates unemployment among young people who, for a variety of reasons, including being trapped in dysfunctional government schools, don't have skills worth the legally imposed minimum wage. The result is not just unemployment, which may be a short-term problem, but a reduction in the opportunities for many young people to acquire the skills and attitudes that will make them more productive over the long run. Even those who do get jobs at the minimum wage are less likely to get one in which employers invests in them by providing training opportunities at the cost of some immediate output. Many young people with little opportunity to continue their formal education, but who are willing to work at a low wage when they have few financial responsibilities, so they can develop the skills necessary to earn a good income in the future, are prevented from doing so by the minimum wage. Eliminating the minimum wage would make it legal for our less advantaged youth to have much the same opportunity for a higher-paying future job that provide our more fortunate youth with a subsidized college. College students are encouraged to work hard now at low wages (often, in the case of college, negative wages) to acquire the human capital to qualify for a high-paying job in the future. Why should we use minimum-wage laws to prevent less fortunate youth from doing the same?

Reduce the Power of Labor Unions

Eliminating some of the legislative privileges that empower labor unions would be an effective way to increase wages. Labor unions can, and do, increase the wages of some workers. But they do so by reducing the wages of others by enough to reduce wages in general. The problem is in political privileges that commonly give unions the power to restrict entry into some occupations to their members, and to render those workers less efficient with rigid work rules limiting what they can do. These practices reduce the productivity of the general labor force. Restricting entry into some occupations increases the wages of union members who work in those occupations, but it increases the number of workers in other occupations where their skills are less valuable. This not only lowers their wages, but reduces the productivity, and wages, of the workers in general by preventing them from moving into their highest-valued employments. By reducing the flexibility of employers to shift workers from one task to another in response to changing conditions, rigid work rules also reduce the productivity, and wages, of workers. Also, politically powerful unions are able to make it almost impossible for a firm to dismiss workers who are no longer needed or who are performing poorly on the job. This reduces productivity not only by encouraging inadequate job performance and by reducing efficient labor mobility, but it also discourages firms from hiring working in the first place. The result is higher unemployment than necessary, with many potentially productive people (usually younger people) failing to get any job, or getting a job that fails to fully utilize their abilities.

As I said at the beginning of this section, all the above policies (or elimination of existing policies) have one thing in common—they would increase wages by increasing economic productivity. They also have another thing in common—they increase wages broadly, indirectly and gradually by establishing an environment in which people can productively cooperate with one another through markets in ways that best serve their collective interest. This means that the better jobs and higher wages will not be readily noticed, and even when they are they will not be seen as the result of government actions for which politicians can easily take credit. So the effectiveness of these policies at creating the type of jobs that politicians are constantly promising to provide does not translate into much political support for them. Politicians find the greatest payoff in receiving credit for the appearance of creating better jobs by reducing wages than not getting credit for policies that increase wages. We next consider some policies that are politically popular because they give the appearance of increasing high wage while actually reducing them.

Policies That Reduce Wages

The policies that are politically popular even though they reduce wages all have two things in common—1) they spread costs over the general public by reducing the productivity of workers and of the economy in general and 2) they make it possible for politicians to concentrate visible benefits on politically influential interest groups while appearing to protect jobs and increase wages. The result is that though the costs exceed the benefits, the costs are spread so thinly that they are noticed by few and associated with the policies causing them by almost no one, while the benefits, both real (wealth transfers) and imaginary (higher wages) are easily appreciated and understood to be the result of particular politicians and policies. Not surprisingly, these policies are, for the most part, the ones that I recommended should be eliminated in the previous section.

Protecting Domestic Jobs with Import Restrictions

When politicians argue for increasing an import restriction, or against reducing such a restriction, they invariably claim that they want to protect high-paying jobs. An import restriction does protect some high-paying jobs, but at the cost of reducing the emergence of other, even higher-paying, jobs, because of the general reduction in productivity that lowers average real wages. But the protected jobs are currently held by relatively few identifiable workers who are typically well represented politically, are fully aware of the benefits they receive from politicians who vote for a trade restriction protecting them from foreign competition and will reward them accordingly with votes and campaign contributions. The resulting loss of even more productive jobs can be safely ignored by politicians since it is widely dispersed and not easily noticed—it is hard to miss a job that has not been created. And even if the loss is noticed, it is not easily seen to be caused by the import restriction. On the other hand, politicians are unlikely to receive much credit for the higher paying jobs that are created by eliminating import restrictions since the market process by which those jobs are created is an indirect one, not easily recognized as resulting from free international trade.

Subsidizing Corporations

Politicians attack business sometimes and praise it other times, depending on current concerns, the business and political fashion. But they are constant providing businesses with subsidizes the public pays for through higher taxes and lower economic productivity. The most common justification for these subsidies is that they creates good jobs. And indeed they do, but only by destroying the more productive jobs that would have emerged if competition had not been distorted by the subsidies and consumers had be allowed to pay less in taxes and spend more of their money on the goods and services that they valued most. Unfortunately, the jobs that are created are visible and easily seen to be the result of government policy, while the higher-paying jobs that are destroyed go unnoticed.

Raising Taxes

Politicians often call for higher taxes as the best way to promote economic growth and create more and better jobs. Supposedly higher taxes will reduce government budget deficits, which will reduce interest rates by reducing government borrowing and the lower interest rates will, the argument goes stimulate business activity and increase wages. This may seems to contradict the thesis of this paper since it suggests that politicians are willing to take an unpopular action—raising taxes—to provide a very general benefit—widespread economic growth and job creation. And indeed, it is easy to find politician calling for cutting taxes. But regardless of the political rhetoric, the political reality is that politician are consistently looking for ways to capture more revenue from the private sector, and the resulting increase in the tax burden does more to reduce wages than to increase them. First, even if raising taxes did reduce the federal budget deficit, it is not likely to have much effect on interest rates. Interest rates are determined in a worldwide capital market, with interest rates often falling when the federal budget deficit is increasing and rising when it is decreasing. Second, increasing taxes seldom reduces the budget deficit, at least not for long. When higher taxes raise more tax revenue, the additional money is invariably used to expand government spending on programs of dubious economic benefit. The effect is to substitute public spending guided by political influences for private spending guided by economic considerations—a sure prescription for reducing productivity and lowering real wages (see next subsection). Third, with higher tax rates, special interests are willing to allocate more resources to lobbying politician for tax loopholes which not only mean fewer resource devoted to productive uses, but reduces the efficiency of those resources that are invested on productive activities with distorted tax incentives. The result is less economic productivity and lower wages. But the political cost of the higher taxes (which is often disguised) and the lower wages (which go largely unnoticed) is more than offset by the political benefits from the plausible pretense that good jobs are being created while securing more of the national income to cater to politically influential interest groups.

Increasing Government Spending

When politicians list the benefits from increasing government spending, they always mention the creation of more jobs. The list of benefits from more spending on highway construction, on recycling, on education, on agricultural subsidies, on parks, on airport expansions, on water diversion products, and the list goes on, always includes the additional jobs that will be created. But the jobs created are a major cost of these spending projects, not a benefit. The jobs necessary to build a road or recycle aluminum cans reduces the number of workers who are not producing value in other activities. Unless this cost is considered, the jobs created will be destroying wealth, as the value created by some of the workers on government-funded projects is less than the value they could be creating elsewhere. And this misallocation of labor is inevitable since politicians can benefit by using tax money to pay high wages in government jobs (which they get credit for creating) by diverting workers out of more productive private-sector jobs at the cost of reduced economic productivity and real wages (which they don't get blamed for causing).

Regulate Labor Markets

Politicians can take credit for protecting and creating jobs by imposing a number of productivity-reducing restrictions on labor markets. To list a few: affirmative-action programs force employers to hire workers on the basis of the racial mix of the communities in which they operate; regulations making it difficult to dismiss unproductive workers; politically mandated employee benefits reducing the flexibility of employers to adjust compensation in ways that attract the best mix of workers at the least cost; minimum wages legislation that reduces the opportunity for many young unskilled workers to get jobs that would provide them with the on-the-job training needed to increase their future productivity; and liberal unemployment payments that reduce the motivation for those who are unemployed to seek new job opportunities. All of these government programs and regulations distort the information and reduce incentives provided by market prices needed to direct workers into those jobs where they generate the most consumer value. With productivity less than it would otherwise be, the result is wages lower than they would otherwise be.

Conclusion

The advantage of the policies that create higher paying jobs indirectly is that they do so by creating a positive-sum settings in which people interact in increasingly productive ways. The same increase in productivity that raises real incomes also increases the general level of wealth, enhancing our lives in a host of ways. For example, as wealth increases, infant mortality decreases, life expectancies (and the quality of life) increase at all age levels, poverty declines, opportunities increase for women and minorities, the environment becomes cleaner, access to the arts increases, more leisure time becomes available, and jobs become safer, more pleasant and higher paying.

The problem with policies that try to create more high-paying jobs directly is that they do so with negative-sum government transfers and protections. Yet this negative-sum approach is politically compelling because politicians receive much of the credit for the benefits while receiving little of the blame for the larger losses.

REFERENCES:

1. Hayek, Friedrich A., Law, Legislation and Liberty, Volume 3, The Political Order of a Free People (Chicago: The University of Chicago Press, 1979).
2. The Economist, “Economics Focus: Poverty and the Ballot Box” (14-20 May 2005), p. 80.

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[i] The Economist (2005, p. 80) recognized this problem when considering the poor record of democratic governments in poor countries at reducing poverty. As they reported, “Democracies have a bias towards ‘direct’ methods of tackling poverty, such as subsidies and hand-outs, which, in the long run, are less effective than ‘indirect’ methods—ie, those that generate faster economic growth.”